

Direct Lending: Innovation Expanding Access to Credit and Supporting Growth

Strong growth of private credit direct lending to middle market and larger companies in recent years has incited market discussion of the long-term risk-return profile of the asset class, its durability in an economic cycle, and its systemic effects. In this market comment we explore a subject that has received less attention, the positive effects of direct lending for borrower companies.

Direct lending expands access to credit in the middle market, reducing the total cost of capital and supporting companies' growth strategies. Private credit direct lending has developed as an innovative investment strategy expanding access to credit in the middle market, therefore reducing equity funding requirements and total cost of capital. Greater leveragability increases participation of private equity which often supports innovation and growth plans. The result is higher growth in key sectors such as Software and Healthcare.

Credit characteristics fitting with direct lending investment strategy are required to take advantage of its benefits. While private credit's high leverage levels are often highlighted, an important mitigant is credit profile selection. Direct lenders' underwriting focuses on companies with strong leveragability characteristics suitable for the strategy. Over 50% of the loans are in the Software, Healthcare and Services industries. Companies are often characterized by solid growth potential, strong stability profiles, and low capital intensity.

Innovative structural features of direct lending can provide important support and flexibility to suitable borrowers. Direct lenders' long-term partnerships with borrowers, concentrated lender groups, flexibility and dry powder enable certain structural features that support leveragability. These include maintenance covenants, payment-in-kind interest toggle options, delayed draw term loan facilities and annual recurring revenue-based structures. For suitable borrowers, the structural features differentiate the asset class and support ability to provide competitive debt quantum and terms.

Certain key attributes of direct lending help it manage through credit stress. Current direct lending default rates are reported to be relatively benign, but this could change in an environment of economic stress. If default rates rise, certain key features of direct lending will help it manage through credit stress and support lender returns. These include the ability to negotiate early due to access and covenants, the ability to increase returns to compensate for the higher risk, and the ability to deploy PIK conversion in some cases to bridge cash flow needs while protecting investment principal.

MARKET COMMENT

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CONTENTS

Sections:	Page
I. Macro Effects	2
II. Credit Characteristics	3
III. Structural Features	4
IV. Credit Stress Management	5

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I. DIRECT LENDING EFFECTS ON ACCESS TO CREDIT, COST OF CAPITAL AND GROWTH

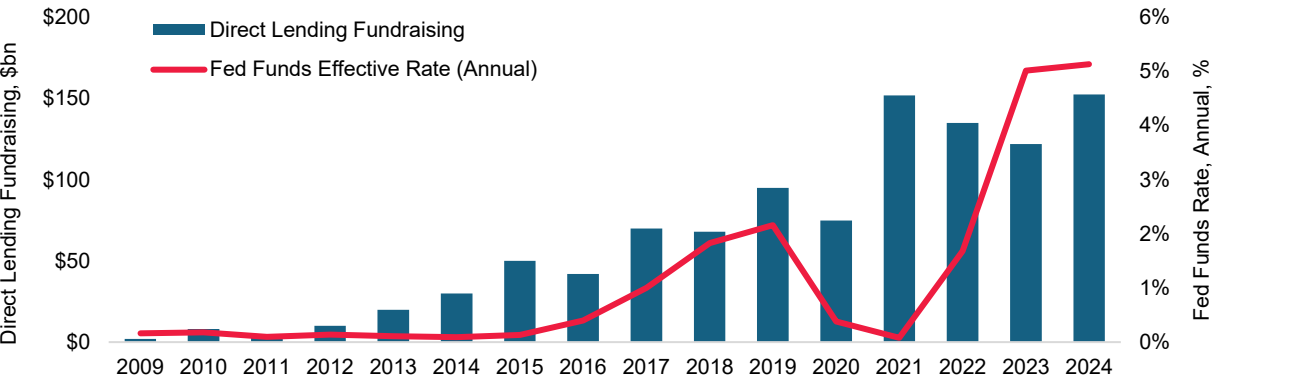
The combination of bank regulation and higher interest rate environment creating a market opportunity with an attractive return profile has driven significant institutional investor capital to direct lending in recent years. Building on success in the middle market, direct lenders increasingly finance larger transactions as dry powder grows. While the high returns for a credit strategy, high leverage levels and the larger transactions often receive press focus, the effect of direct lending on credit accessibility and cost of capital in the middle market is an economic benefit of the asset class that deserves more attention.

Greater access to credit in the middle market. Direct lending meaningfully expands access to credit in some sectors of the middle market, enhancing capitalization optionality for numerous companies. It provides an innovative approach to financing companies with characteristics conducive to credit, notably businesses combining solid stability and growth profiles (Software, Healthcare). With about two-thirds of direct lending transactions financing private equity-owned companies, direct lending expands participation of private equity in the middle market, which carries meaningful benefits for borrower companies and the economy.

Lower weighted average cost of capital. While the relatively high cost of direct lending debt is often highlighted, it is very competitive when compared to the cost of equity capital which it commonly replaces for middle market companies. For many private credit-financed middle market borrowers, credit financing alternatives can involve a lower debt quantum with a cost that is still relatively high. As an illustrative example, the WACC of a middle market company with about half of its capital base financed with private credit is meaningfully lower than that of a largely equity-financed company with lower cost of debt. Additionally, higher leveragability is often positive for company valuations due to attractiveness to private equity, effectively implying a lower resulting cost of equity capital.

Higher growth. In the middle market, private equity capital often supports innovation and growth business plans. Availability of credit financing can have a significant positive effect on a company’s ability to execute a growth plan (whether organically or through M&A), as compared to relying solely on growth equity. Direct lending facilities are often specifically structured to facilitate acquisition plans with features such as delayed draw tranches. Private credit lenders’ available dry powder can enable portfolio companies to be more forward-leaning with their strategic objectives. The result is higher growth in key sectors of the economy such as Software and Healthcare, among others.

Exhibit 1
Substantial growth in direct lending fundraising in recent years, supported by high interest rate environment



Sources: Preqin, Federal Reserve

II. CREDIT CHARACTERISTICS OF DIRECT LENDING BORROWERS

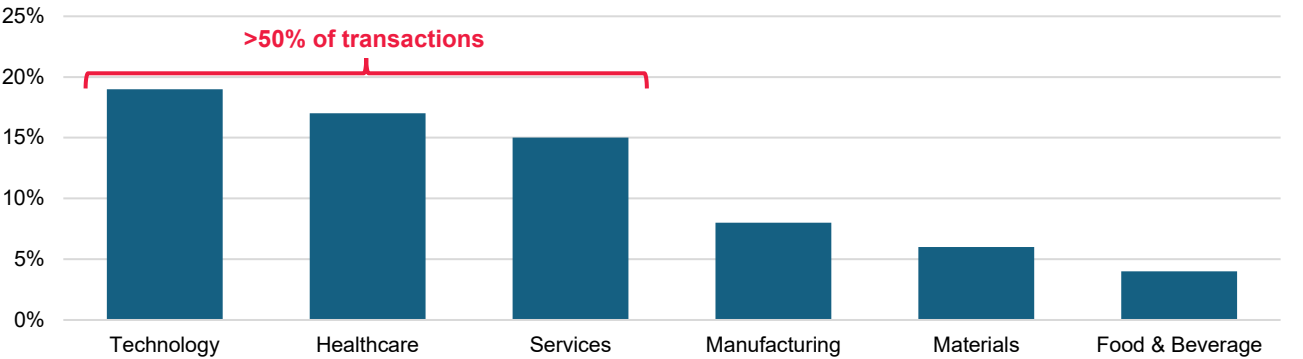
Direct lending as an investment strategy balances high leverage and high investment returns. At loan initiation, total leverage levels are typically in the 6x-7x range (higher for some high-growth profiles), while interest coverage levels average around 1.5x. Free cash flow can be close to breakeven or even negative initially, with liquidity provided by prefunded cash balances or available committed lines, and with an expectation of a ramp up in cash flow generation as revenue grows. While high leverage levels and limited cash flow are often highlighted as a source of heightened risk, a key mitigating factor is direct lenders’ underwriting selection which typically focuses on credits with above-average leveragability that are suitable for the investment strategy.

Concentration in leverageable industries. Over half of direct lending is estimated to be concentrated in the Software/Technology, Healthcare, and Business Services industries. These industries are characterized by leveragability above the overall market average due to their combination of growth, stability, low capital intensity and high cash flow generation potential. Industries that have a history of volatility or cyclicalities are generally underrepresented in direct lending portfolios. Within focus industries, private credit investment is often concentrated in sectors with positive secular trends or innovation driving relatively higher growth trajectory.

Lenders seek out borrowers with high leveragability characteristics. Companies selected for private credit financing commonly have credit characteristics that support leveragability. The most significant of these is often a strong stability profile, with low cyclicalities and sticky or recurring revenues. Companies often benefit from business differentiation or niche positions, with less exposure to significant competitive threats or commoditization. Financial profiles often exhibit ample revenue growth and low capital intensity. While on average profitability levels are adequate, in certain growth plans profitability can be low or negative initially as the business ramps but is typically projected to normalize after a certain period before debt maturity.

Relatively low effect of international trade changes. On average, companies financed with private credit are not very exposed to trade changes due to the nature and focus of their businesses. Middle market companies are commonly US-centric. Companies in Software, Healthcare, Services sectors often have little reliance on imported components or products, and benefit from relatively simple supply chains. Direct lending portfolios are generally underweight sectors related to discretionary consumer spending.

Exhibit 2
Technology, Healthcare and Services consistently largest industries for direct lending (% of deals June 2025 YTD)



Source: Pitchbook LCD June 2025 year to date.

III. DIFFERENTIATED STRUCTURAL FEATURES OF DIRECT LENDING

Innovative structural features of the direct lending market arose from the characteristics of its borrowers and lenders. On the borrower side, common characteristics include relatively small size, ample growth, M&A plans, limited but growing cash flow, and private equity ownership. On the lender side, key features include buy-and-hold strategy, flexibility of return profiles, and available dry powder. As lenders and borrowers seek to maximize leveragability, these characteristics enable them to employ structural features that provide key advantages.

Maintenance covenants. Direct lending agreements commonly include maintenance financial covenants, typically a total leverage test (multiple covenants are rare). Maintenance covenants are valuable as a protective feature, appropriate for private credit long-term buy-and-hold lending relationships, particularly for smaller companies and at higher leverage levels. However, for larger borrowers where private credit often competes more directly with the covenant-lite syndicated loan market, maintenance covenants are sometimes set at loose levels or dropped entirely.

Payment-in-kind interest options. Direct lending transactions often combine limited cash flow with relatively high interest rates, and institutional investors often focus more on total rate of return than its form. In such situations, a PIK-toggle option to defer cash interest and accrue in-kind interest at a higher rate can provide valuable flexibility for the borrower while being acceptable to the lender. PIK-toggle options are more common in the upper middle-market, where they are a differentiating feature of private credit compared to other debt financing alternatives.

Delayed draw term loans (DDTL). Private credit transactions often feature small club groups of investors with available dry powder, combined with private equity-owned borrowers executing rollup acquisition plans. In such situations, direct lenders can offer valuable M&A funding flexibility via committed DDTL facilities (often up to two years). DDTL facilities can be more complex to administer in syndicated markets that involve large investor groups.

Annual Recurring Revenue (ARR) structures. In industries with high revenue stability and strong growth (e.g. Software) direct lenders have employed a structure that replaces EBITDA with ARR in the calculation of leverage ratio until a certain date when a conversion to EBITDA occurs. The structure is utilized for businesses with strong scale economies and ability to reduce costs meaningfully while sustaining revenues. The innovative structure has expanded the total addressable market for credit in certain growth sectors. To date, it is estimated that about half of the deals that came up for conversion successfully converted to EBITDA-based metrics, with the balance amended to delay conversion.

Exhibit 3
Presence of Maintenance Covenants in Direct Lending

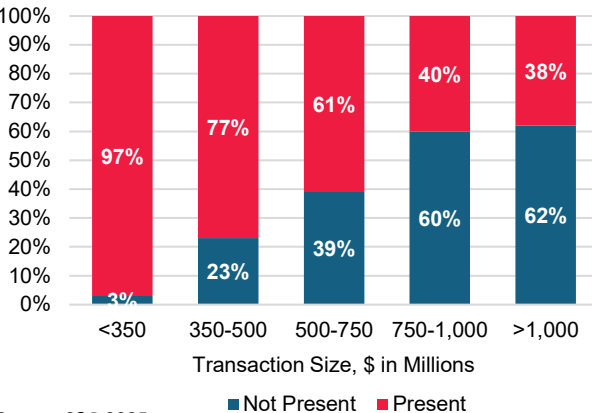
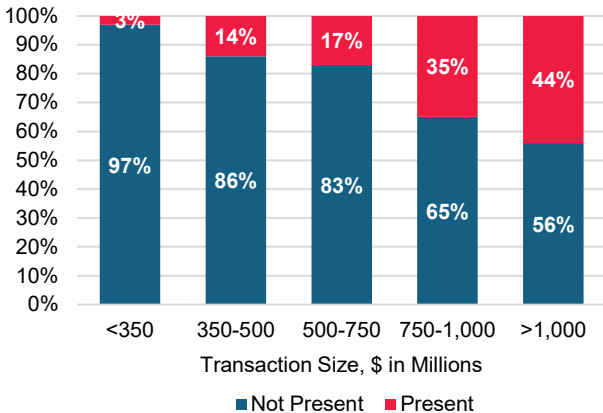


Exhibit 4
Presence of PIK toggle options in direct lending



Source: S&P 2025.

IV. DIRECT LENDING CREDIT STRESS MANAGEMENT

Estimated direct lending default rates and recoveries are reported to be generally in line with syndicated leveraged loans. Default rates reported in recent periods by various data providers are relatively benign at 1%-2% excluding selective defaults, and in the 5% area including selective defaults. In any potential environment of macroeconomic stress, direct lending default rates could be expected to increase, as could be the case in other leveraged debt markets. Direct lenders’ focus on credit profiles with low cyclicalities and high stability may help weather downturns. Additionally, certain market and strategy attributes support direct lenders’ ability to manage through credit stress.

Long-term holders with access, well positioned to have a seat at the table early. Direct lenders’ concentrated lender groups with strong access to management and owners, often with maintenance covenants, are generally well positioned to negotiate restructuring terms if credit stress develops. While in syndicated markets some lenders rely on liquidity to exit before distress (sometimes resulting in price declines once distress becomes apparent), direct lenders’ more illiquid but long-term partnership approach often positions them to start amendment dialogue early, seeking adequate return for the risk and possibly influencing the company’s strategy as risk is perceived to increase.

Strong returns provide cushion, with ability to increase return as level of risk increases. The strong return profile of direct lending provides flexibility to work with borrowers to manage credit stress as long as there is no material impairment of the loan principal. The economic effects of extending payment terms or converting to PIK interest can be mitigated by amendment fees and higher interest rates. The private and relatively illiquid nature of the asset class makes it less reactive to valuation changes, and ultimately the measure of returns is realization of interest and principal, which can be attractive in higher-risk situations where returns have been augmented over time.

PIK conversion can be a useful credit stress management tool. While press reports sometimes mention PIK conversion in private credit as a crutch to sustain excessive leverage, in many situations it can be a useful stress management tool with benefits for both borrowers and lenders. PIK conversion typically increases the interest rate meaningfully (whether through toggle or amendment), compensating institutional investors focused on total return for the higher risk. For the borrowers, the resulting higher cost of capital is still lower than the cost of equity. Private credit often supports high-growth strategies, where a temporary PIK conversion to preserve cash flow – if revenue growth remains strong – does not necessarily indicate impairment of the debt principal and can in fact increase lenders’ realized returns.

Exhibit 5
Estimated direct lending default rates reported to be similar to syndicated leveraged loans

